United States Court of Appeals

for the Second Circuit

APPELLANT'S PETITION FOR REHEARING EN BANC

76-7565

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 76-7565

8/26

PITTSBURGH COKE & CHEMICAL COMPANY,

Petitioner,

-against-

LOUIS J. BOLLO,

Respondent.

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P/S

PETITION OF PITTSBURGH COKE & CHEMICAL COMPANY FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

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THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

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PITTSBURGH COKE & CHEMICAL COMPANY, :

Plaintiff-Appellant, :

-against- : No. 76-7565

LOUIS J. BOLLO, :

Defendant-Appellee. :

- x

PETITION OF PITTSBURGH COKE AND CHEMICAL COMPANY FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

Plaintiff-Appellant Pittsburgh Coke & Chemical Company ("PCC") hereby petitions the Court for rehearing of this case pursuant to Rule 40(a) of the Federal Rules of Appellate Procedure.* Rehearing is appropriate, and en banc rehearing is respectfully suggested, because the necessary effect of the Court's opinion, given facts undisputed in this record, is to render virtually meaningless the warranty

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* The Court's decision was released on August 12, 1977 in an opinion by Judge Moore joined by Judges Mulligan and Smith, affirming the decision of the District Court reported at 421 F.Supp. 908 (E.D.N.Y. 1976).

of a selling company that its financial statements have been prepared in accordance with "generally accepted accounting principles".*

ARGUMENT

In the written agreement pursuant to which defendant-appellee Louis J. Bollo ("Bollo") sold his shares of Standard Aircraft Equipment Company ("Standard") to PCC, Bollo expressly warranted that Standard's financial statements had been prepared in accordance with "generally accepted accounting principles applied on a consistent basis throughout the periods involved." Inventory, comprising the bulk of Standard's assets because Standard acted as middleman in the distribution of aircraft parts, was therefore required to have been valued in accordance with generally accepted accounting principles.

PCC's claim was that Bollo's express warranty had been breached because those principles had not been observed, with the result that Standard's inventory had been substantially overvalued.

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* We do not seek rehearing with respect to the remainder of the Court's opinion.

The controversy over inventory concerned the proper accounting for slow-moving parts. Since Standard bought millions of dollars of parts every year in anticipation of resale to airlines and other purchasers and it was inevitable that some parts would not sell as well as originally anticipated, Standard was left holding substantial quantities of these items. While some of these slow-moving items could have been physically warehoused as "insurance items"* rather than merely "junked", appropriate adjustments on Standard's books and financial statements became necessary if "generally accepted accounting principles" were to be followed. Inventory items are usually valued at cost; to continue to value probably unsaleable parts at cost as years pass and the quantity of these parts accumulate would, however, seriously distort the financial statements of the company. Generally accepted accounting principles thus require, as indeed Standard's financial statements in every case represented, that inventory be valued at the "lower of cost or market" which, for inventory of this kind, means writing off those items for which the probability of sale is low.

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* "Insurance items" were "parts infrequently or rarely required but productive of goodwill when available to customers who needed such a part quickly and could not obtain it from the manufacturers." 421 F.Supp. at 927.

The expert testimony at trial -- not disputed -- as well as the inventory write-off records themselves -- indisputable -- established that, notwithstanding the representations in Standard's financial statements (which Bollo expressly warranted were prepared in accordance with "generally accepted accounting principles"), Standard's inventory had, in fact, not been carried at the "lower of cost or market" and had, in fact, not been valued in accordance with "generally accepted accounting principles." According to the expert testimony, proper valuation of inventory requires that adequate provision be made on a consistent basis to write-off slow-moving items that are probably unsaleable. Extensive testimony was presented on the methodology that Bollo and Standard had used in writing off the slow-moving items in Standard's inventory.* Expert testimony showed that the

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* The District Court, in summarizing the inventory write-off policies of Standard, cited the testimony of Ernest Rushia, the Vice President of Materiel of Standard who was in charge of inventory. The testimony was that Standard did not undertake any write-offs of slow-moving inventory during three of the years in the period 1962 through 1968. In the four years during that period when there were write-offs, the amount to be written off was selected arbitrarily. Rushia testified that Bollo had simply picked a dollar figure and given it to him with no instructions as to which items to write-off nor any explanation of how Bollo had arrived at the dollar figure specified.

(footnote continued on next page)

methodology actually used and the inventory write-off results actually obtained by Standard were arbitrary, haphazard, inconsistent and totally contrary to generally accepted accounting principles. The methodology bears no plausible relationship to the actual amount of unsaleable inventory and Bollo, neither at trial nor in his brief on appeal, made the slightest effort to defend it.

Standard's inventory write-off records are in evidence. These records, which Bollo cannot and does not dispute, speak for themselves. They show that there were 90 product codes into which Standard's inventory was classified: in 1962, only 3 out of 90 were even reviewed for slow-moving items; in 1963, 0 out of 90 were so reviewed; in 1964, only 2 out of 90 were reviewed; in 1965, only 14 out of 90 were reviewed, in 1966, 0 out of 90 were reviewed; in 1967, only

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(footnote continued from preceding page)

After being given the dollar figure by Bollo, Rushia began to go through the inventory records one-by-one, writing off items of which there had been no sales for at least two years. When he reached Bollo's predetermined number, he stopped examining the inventory records and wrote off no more slow-moving items that year -- regardless of how many such items remained on the books! It should thus come as no surprise that Bollo did not - and obviously could not - call as witnesses Standard's former auditors, notwithstanding his prior representation that he would do so. There was thus no expert testimony whatever to the effect that "generally accepted accounting principles" had been adhered to.

8 out of 90 were reviewed; and in 1968, 0 out of 90 product codes were reviewed. Consequently, in the seven year period 1962 through 1968, the overwhelming majority of Standard's 90 product codes were never even reviewed for slow-moving items.

How this procedure could conceivably be deemed in accordance with "generally accepted accounting principles", particularly when experts testified unequivocally that it was not, without doing violence to fundamental tenets of accounting and warranty is the issue underlying this petition for rehearing. The holding that the foregoing is consistent with generally accepted accounting principles will surely come as a profound shock to the accounting profession, inasmuch as such a holding effectively renders the term "generally accepted accounting principles", at least as applied to inventory accounting, meaningless.

Having established that the warranty was breached, PCC sought to prove damages through expert testimony as to how much would have been written off had generally accepted accounting principles been followed. This was an area of some controversy, particularly over the applicability and

effect of a so-called "two-year rule".* The contentions of Bollo in this area, however, did not in any way challenge the proposition stated above - namely, that the actual methodology and results regarding the accounting treatment of slow-moving inventory at Standard were utterly inconsistent with generally accepted accounting principles.

In its opinion, the Court rejected PCC's argument with the following explanation:

> "The term 'generally accepted accounting principles', as used in the sale of Standard to PCC, should not be interpreted *in vacuo* but only in relation to the particular type of business involved. 'Generally accepted accounting principles' are not synonymous with any specific inventory write-off policy. The unique nature of Standard's business should make it self-evident that its retention of parts and equipment for substantial periods of time and its ability to supply some old part when needed were one of the foundation stones on which its business had been built. As the District Court found, these were 'parts infrequently or rarely required but productive of goodwill when available to customers who needed such a part quickly and could not obtain it from the manufacturers.' 421 F.Supp. at 927. The practice of Standard in handling its write-off

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* The undisputed expert testimony was that a period of two years represented the longest permissible period, established the absolute minimum standard, and yielded the smallest amount of write-offs consistent with generally accepted accounting principles when applied to a company, such as Standard, in the repair parts business generally and in the aircraft parts industry in particular.

> policy must be judged in relation to its own operation, and not by any stereotype accounting formula."

The Court appears to have misapprehended the distinction between the retention of parts and the valuation of retained parts. In this case, Standard had a huge quantity of inventory items for which it had paid over $380,000 and as to which it could only have hoped to sell an item "rarely" or "infrequently". It was a gross violation of generally accepted accounting principles to continue to value those inventory items on its books at full cost if Standard could only hope to sell a small fraction of those items or to realize a small fraction of that cost.* If the expense of retention or storage was negligible, however, it may have been prudent to retain those parts physically in order to make that occasional sale to foster the goodwill of customers - but they should nonetheless have been written down to reflect their improbability of sale. Thus the question of the physical retention of parts was a matter of business judgment simply not at issue in this suit; but the question of how those parts were to be valued and reflected in Standard's financial statements was

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* It also contradicted the representation in the financial statements that inventory was valued at the "lower of cost or market."

exclusively a matter of accounting and subject to accounting principles.

It may be worth noting, at the risk of repetition, that the "practice of Standard in handling its write-off policy" was deficient and not in accordance with "generally accepted accounting principles" because, "judged in relation to [Standard's] own operation", the practice was arbitrary, inconsistent and bore no relation to the actual amount of unsaleable inventory -- not because it differed from any "stereotype accounting formula." At trial, PCC used a formula to prove the amount of damages, not to prove liability. This was done because, as PCC's expert witnesses testified,* such formulas were the accepted method used to write-off inventory by companies in the repair parts business, including Standard's competitors.

The Court went on to state:

> "Furthermore, PCC was apparently not buying Standard to liquidate it but to operate it as a going concern - hence a continuance of its write-off policy might well have been indicated."

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* These expert witnesses were not interpreting the term "generally accepted accounting principles" "in vacuo" but, throughout their testimony, specifically "in relation to the particular type of business involved" at Standard. (JA 387-454, 465-469, 475-477, 513-518).

It is perfectly true that PCC purchased Standard to operate it and not to liquidate it; but that PCC was going to operate Standard as a going concern would not in any way affect the question of whether the valuation of Standard's inventory was consistent with generally accepted accounting principles.* If the methodology was contrary to accounting standards before the closing, it would have been equally so after the closing.

Finally, the Court stated:

> "Nor does the fact that in 1970 PCC chose to make substantial additional write-offs bespeak either a previous inaccurate or fraudulent handling of inventory by Standard."

PCC has never contended that its own decision to make substantial additional write-offs above those previously made showed either inaccurate or fraudulent handling of inventory. Both in the District Court and its brief before

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* The "going concern" argument raised by Bollo in his brief was that as PCC valued the stock by projecting earnings, therefore a balance sheet item would not affect that valuation. Our response to this fallacy was that the absence of $380,000 which had been warranted to be part of assets, whether due to undervalued inventory or to embezzled funds, decreased the value of the shares of the company because the assets, had they not been "lost", could have been either dividended to the shareholders or used to generate additional earnings.

the Court of Appeals, PCC contended that there should be liability in this case because there is no accounting justification for the methodology followed by Standard in its write-off policy and no accounting defense for the incompleteness of the write-offs actually taken by Standard. PCC only sought damages for that quantity of inventory which should have -- must have -- been written off using the formula, consistent with generally accepted accounting principles, which all the expert testimony concluded was most favorable to Bollo.

CONCLUSION

It has long been commonplace for stock in companies to be sold based upon warranties identical in form and substance to those used by Bollo and PCC; in such transactions, it is the norm for financial statements of the company in question to be proffered by seller to buyer accompanied by a warranty that those statements were prepared in accordance with "generally accepted accounting principles". If those "principles" are hereafter to mean little more than the inconsistent and idiosyncratic whims of the seller, entirely new mechanisms will be required to protect buyers -- of whatever sophistication -- against those from whom they are

purchasing. We do not believe either the federal securities laws or the common law of New York permits such a result.

We respectfully urge that rehearing be granted and suggest the desirability of rehearing *en banc*.

Dated: August 26, 1977

Respectfully submitted,

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UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

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Petitioner,	:	
-against-	:	**AFFIDAVIT OF SERVICE**
		Index No. 76-7565
LOUIS J. BOLLO,	:	
Respondent.	:	

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

PETER K. DEMMERLE, being duly sworn, deposes and says:

1. I am over the age of 18 years and not a party to this action.

2. On the 26th day of August, 1977, I served the annexed Petition for Rehearing upon:

Paul Weiss, Goldberg, Rifkind,
Wharton & Garrison
345 Park Avenue
New York, New York 10022

by depositing a true and correct copy thereof in the United States Post Office at 73 Pine Street, New York, New York 10005, enclosed in a stamped, sealed envelope addressed to the above-mentioned attorney.

Peter K. Demmerle

Peter K. Demmerle

Sworn to before me this

26th day of August, 1977

Robert R Cawthra

Notary Public

ROBERT R. CAWTHRA, JR.
Notary Public, State of New York
No. 31-4609710
Qualified in New York County
Commission Expires March 30, 1979